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10-3

# **U.S. Farm Policy Reforms: Domestic and International Implications**

By:

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## Executive Summary

With the Doha Round of World Trade Organization (WTO) negotiations at a standstill, substantial liberalization of agricultural trade remains elusive. One obstacle to progress is that “dirty decoupling” of farm subsidies from production decisions in developed countries has discredited the constructive reform strategy of reducing the production- and trade-distorting effects of farm support programs. Border measures in the developed world, often put in place to accommodate domestic policies, are also problematic.

The United States has a long history of farm policy interventions. The omnibus multiyear farm bills provide extensive income and price support to farmers of major crops. Protective trade measures such as tariff rate quotas (TRQs) are widely used to supplement commodity support programs. U.S. agricultural policy affects a diverse group of stakeholders both within the United States and internationally. These stakeholders usually have very different and sometimes conflicting interests.

U.S. agricultural and trade policies have evolved in the past century in response both to the changes occurring in agriculture and the economy and to budgetary and trade pressures. Yet they have also retained many features dating back to the early 1930s. Critics have long argued that these policies are outdated and in many ways detrimental to U.S. domestic agriculture and to the world economy. There is substantial pressure for additional reforms to U.S. agricultural policy, even though the 2002 Farm Bill is not scheduled to expire until the end of 2007.

There are no clear rules for undertaking reform, however, and it remains uncertain exactly what the next farm bill would look like. This analysis provides some generic options for achieving further agricultural policy reform in the United States. Possible policy options are offered in three broad areas: domestic support, market access, and export subsidies. Although these trade and domestic policies are discussed separately, they should be treated as linked and requiring coordinated reform efforts.

There is also the issue of political feasibility if any reform is to occur. To the extent that current domestic and trade policies prop up domestic prices and generate higher farm incomes, U.S.

farmers and farm groups are loath to support a change. Nonetheless, several steps can be envisioned that would improve the prospects for adoption of reform in the United States. Effective mechanisms might include an elimination of the permanent legislation (to which the periodic farm bills are technically amendments) for farm support programs in the United States and a new WTO agreement on agriculture built on tighter limits on U.S. amber box measures as well as commitments to greater reductions in tariffs and export subsidies. Past experience suggests that a policy change will require substantial support from producers. For producers who are net losers, compensation will be necessary and should be made lucrative enough to bring about the necessary support.

Your assignment is to design a policy reform package (in terms of domestic support, market access, and export subsidies) that is both politically feasible in the United States and beneficial for developing countries.

## Background

### Overview

With the Doha Round of WTO negotiations at a standstill, substantial liberalization of agricultural trade remains elusive. One obstacle to progress is that “dirty decoupling” in developed countries has discredited the constructive reform strategy of reducing the production- and trade-distorting effects of farm support programs, just as “dirty tariffication” has marred the elimination of qualitative trade restrictions in the Uruguay Round and left high levels of protection in place.<sup>1</sup> Decoupling of payments from production decisions is supposed to eliminate distorting policy effects. But whenever world prices are low, developed-country governments quickly step in and expand their payments to farm producers, making the claim that these payments are “decoupled”—that is, isolated from production decisions—rather suspicious.

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<sup>1</sup> “Dirty decoupling” and “dirty tariffication” refer to the situation where efforts to decouple subsidies from farmers’ production decisions or to reduce nontariff barriers to trade have actually led to more production-contingent subsidies or higher tariff rates.

Beyond subsidies, border measures in the developed world are also problematic. These border measures are often put in place to accommodate domestic policies. For example, when a government attempts to support the domestic price of an importable commodity at a level higher than the world market price, it must impose high tariff or nontariff barriers to keep foreign producers from flooding the market with products at lower world market prices and taking advantage of higher domestic prices. Or, if a government policy (like imposition of price floors) induces more production than can be accommodated on the domestic market, governments must subsidize exports onto world markets. In both cases, governments rely on border measures to shift the burden of adjustment from the domestic to the world market.

### U.S. Farm Policy

The United States has a long history of farm policy interventions. The omnibus multiyear farm bills provide extensive income and price support to farmers of major crops. The current farm bill, the Farm Security and Rural Investment Act (FSRIA) of 2002 (or 2002 Farm Bill), which governs agricultural programs through 2007, was signed into law in May 2002.<sup>2</sup> Although the 2002 Farm Bill introduces some new policies to the array of agricultural commodity programs, in many ways it extends provisions of the 1996 farm bill and the ad hoc emergency spending bills of 1998–2001. For example, the 2002 Farm Bill continues marketing assistance loans, which existed under previous U.S. farm law. Production flexibility contract (PFC) payments of the 1996 farm bill are replaced by direct payments. A new countercyclical payment is

established to provide an improved farm income safety net for major crop producers. As in the previous farm bills, the heart of the 2002 bill lies in commodity support programs. In addition, the bill contains provisions on agricultural trade, rural development, domestic food assistance, foreign food aid, conservation, crop insurance, farm credit, forestry, and agricultural research.

The commodity support programs affect producers of a wide variety of agricultural commodities. The program-covered commodities include wheat, feed grains (corn, sorghum, barley, oats), cotton (upland and extra-long staple [ELS]), rice, soybeans, other oilseeds (sunflower seed, canola, rapeseed, safflower, flaxseed, mustard seed), milk, peanuts, beet and cane sugar, wool, mohair, honey, dry peas, lentils, small chickpeas, and tobacco. Altogether, these commodities account for approximately 40 percent of all farm cash receipts (Becker and Womach 2002). Other commodities that normally receive no direct support include meats, hay, poultry, fruits, nuts, vegetables, and nursery/greenhouse products. But even producers of these items can be affected indirectly by the commodity programs. In addition, provisions in the law allow the U.S. Department of Agriculture (USDA) to provide discretionary direct subsidies to non-program commodities whenever deemed necessary.

The commodity programs in the 2002 bill are diverse, and the types and levels of statutory support employed vary by commodity. Some are supported by only one method; others receive their support through a combination of program tools. Broadly speaking, commodity program supports in 2002 Farm Bill can be classified into two major categories: farm income support and commodity price support. Farm income support programs make payments to farmers to supplement their income without directly supporting commodity marketing prices. In the 2002 Farm Bill, this type of support includes annual fixed decoupled payments (direct payments) and countercyclical deficiency payments for grains, cotton, oilseeds, and peanuts; countercyclical deficiency payments for milk; and nonrecourse marketing loans gains (MLGs) and loan deficiency payments (LDPs) for grains, cotton, peanuts, oilseeds, wool, mohair, honey, dry peas, lentils, and small chickpeas. Commodity price support programs affect the price of commodities directly by setting minimum prices, restricting production or sales, and/or regulating

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<sup>2</sup> Permanent legislation for farm support refers to those laws that would be in force to authorize various agricultural programs in the absence of all temporary amendments (farm bills). The Agricultural Adjustment Act of 1938 and the Agricultural Act of 1949, as subsequently amended, serve as the basic laws authorizing the major commodity programs. Technically, each new short-term farm bill amends the permanent legislation for a specified period. The permanent statutory provisions, as amended over the years, dictate how commodity programs can be implemented unless steps are taken to amend, suspend, or repeal parts of them. The most recent legislation modifying the effect of the permanent provisions through such actions was the 2002 Farm Bill. As usual, some permanent provisions were left unchanged by the 2002 Farm Bill and therefore still apply to current programs.

imports. In the current farm bill, price support programs affect four commodities: peanuts and tobacco by marketing quotas (which were bought out in 2004),<sup>3</sup> sugar by marketing allotments and import quotas, and milk by surplus purchases.

### Farm Program Payments

Subsidy payments to farmers vary across years because many program benefits are contingent on market prices (all in nominal terms). Figure 1 shows commodity and conservation program payments from 1996 to 2006. Total payments to farmers have increased since 1998, reaching a record US\$23 billion in calendar year 2005. These payments were forecast to decline, however, to about US\$18 billion in calendar year 2006 as prices were expected to slightly recover. Under the 1996 Act, PFC payments decreased according to a payment schedule for major field crops, from a high of US\$6.4 billion in calendar 1997 to US\$4 billion in calendar 2001. The 2002 Farm Bill replaced PFC payments with fixed direct payments. These payments, based on historic acreage and yields, are considered "decoupled"—that is, not based on current production or prices. Direct payments are projected at US\$5.25 billion annually over the remainder of the 2002 Farm Bill.

Low commodity prices led to significant increases in LDPs and MLGs in 1998–2001 and again in 2004–05. The marketing assistance loan program, reauthorized in the 2002 Farm Bill, prevents the buildup of publicly owned stocks (major field crops) by providing alternatives to defaulting on commodity loans. LDPs and MLGs provide farmers with per-unit revenue insulation when prices are low. Ad hoc emergency assistance legislated in 1998–2001 also played a prominent role when prices were low during this period. Instead of seeking ad hoc legislation, the new countercyclical payments authorized in the 2002 Farm Bill offer a certain provision to help stabilize farm revenues. Countercyclical payments rose in 2005, again reflecting lower commodity prices.

### U.S. Agricultural Trade Policy

U.S. agricultural trade policy has historically been designed to match domestic farm policy. For example, when the rules for the General Agreement on Tariffs and Trade (GATT) were written in 1947, the United States managed to keep agricultural trade exempt from the general rules prohibiting the use of import quotas, provided that there were domestic production controls on the product in question. In addition, the United States insisted that the GATT rules for agriculture allow the use of export subsidies since it would be impossible to compete in export markets without export subsidies when domestic price support programs had maintained the internal price of the product above the world price.

At the conclusion of the Uruguay Round in 1994, all the import quotas and export restraints in the United States were converted into tariffs, many of which were very high. In order to ensure some market access for agricultural products, the United States established a tariff rate quota (TRQ) system that covered some 24 percent of agricultural tariff lines. For most products in the TRQ system, the tariff level for in-quota quantities is fairly low, averaging about 10 percent. The over-quota tariff levels, however, are prohibitively high, with an average of 52 percent.

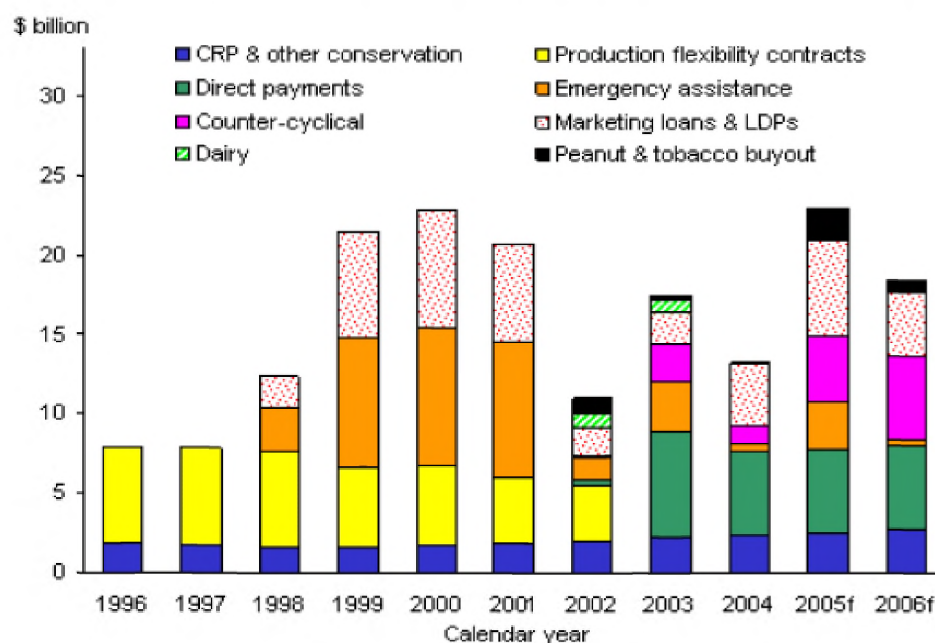
In the Uruguay Round a tariff-cutting formula was designed to allow countries to protect their sensitive agricultural products. Developed countries were required to reduce tariffs by an average 36 percent with a minimum cut of 15 percent on each tariff between 1995 and 2000. As a result of the recent round of tariff cuts, U.S. bound tariffs on most agricultural products are relatively low, averaging about 12 percent. This relatively low figure, however, masks some high levels of protection for a number of products including dairy, sweeteners, and tobacco (Figure 2).

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<sup>3</sup> The quota buyout is the purchase of marketing quotas by the federal government for the purpose of phasing out such quotas, thus significantly reducing price distortions and eventually government outlays.



Figure 1: Commodity and Conservation Program Payments, 1996–2006



Note: CRP = Conservation Reserve Program. f = forecast.

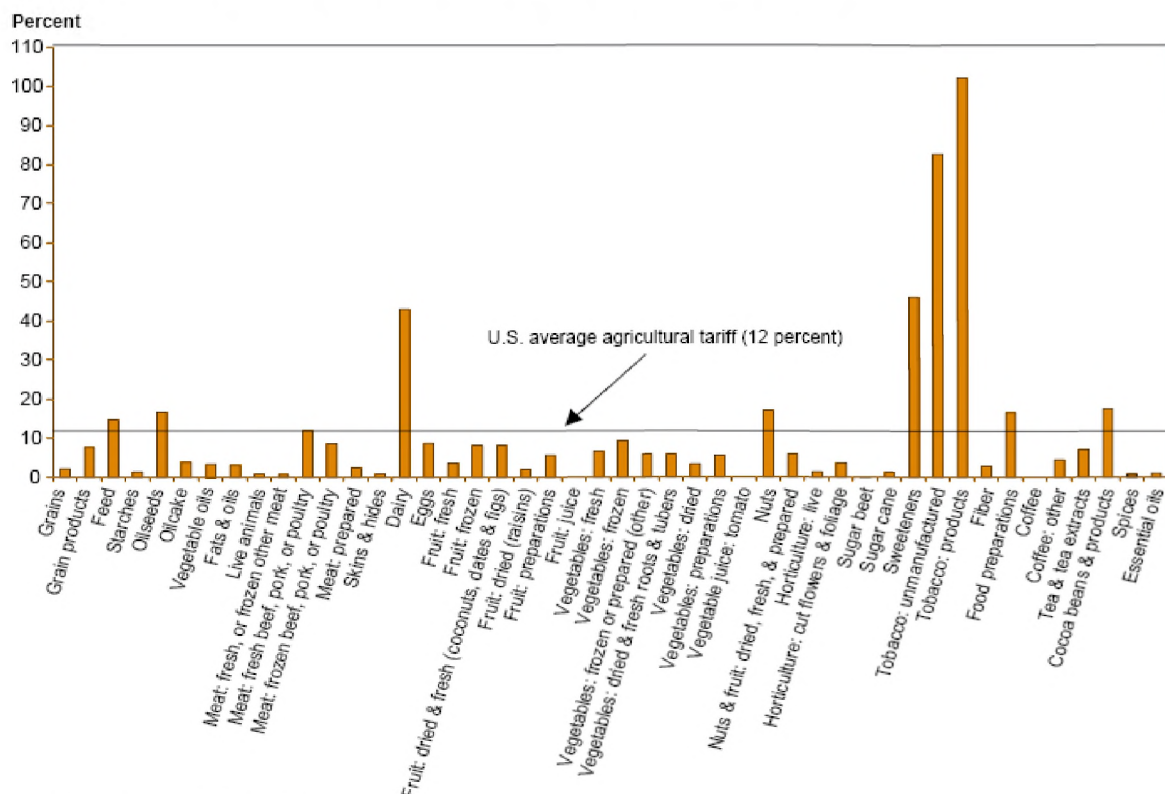
Source: ERS, USDA 2006a.

Table 1: TRQs in the United States

Average tariff levels (%)			Number of tariff lines			TRQ lines as percentage of total
Tariff (all lines)	In-quota tariff (TRQ lines)	Over-quota tariff (TRQ lines)	Tariff-lines without TRQs	Tariff-lines with in-quota tariffs	Tariff-lines with over-quota tariffs	
12	10	52	1,198	190	182	24

Source: ERS, USDA 2006b.

Figure 2: Average URAA Bound Tariff Rates by Commodity Group



Source: ERS, USDA 2006b.

Within the 46 product categories shown in Figure 2, individual tariffs exceed the overall average tariff rate of 12 percent in 9 categories, of which 7 contain megatariffs (tariffs over 100 percent).<sup>4</sup> The highest tariffs in the United States are levied on the imports of tobacco products and unprocessed tobacco. Even though most of the tariffs in the two tobacco categories are below 10 percent, the averages are inflated by the presence of 4 megatariffs, each equal to 350 percent. Megatariffs are also found in dairy products, oilseeds, nuts, and sweeteners. All the 24 megatariffs in the United States form the over-quota tariff in a TRQ, so that only limited market access is being provided for these products at the lower in-quota rates.

<sup>4</sup> Tariffs are bound rates based on final implementation of the Uruguay Round Agreement on Agriculture (URAA). In-quota TRQ, over-quota TRQ, and all non-TRQ rates were used to calculate simple unweighted average tariffs.

The 2002 Farm Bill authorizes a series of programs designed to increase exports of U.S. farm products. These programs, which are extremely popular with U.S. commodity groups and export firms, include export credit guarantee programs, market development programs, export enhancement programs, food aid and development programs, technical barriers to trade, and trade-related programs in other titles. It is important to note that some of the export support programs provide direct subsidies (US\$80 million in 1999) that are prohibited by WTO rules. The United States was thus committed to reduce them by 36 percent in value and 21 percent in volume from the 1986–1990 base period during the five-year implementation period from 1995 to 2000. The United States is a minor export subsidizer, however. In comparison, the EU has provided the largest subsidies to exporters, amounting to US\$5 billion in 1999.

## Stakeholders

### Domestic Stakeholders

The essential aim of U.S. agricultural support and trade policy is to guarantee adequate farm income, support high and stable domestic commodity prices, and promote foreign trade. Domestic farm policy as reflected in the multiyear omnibus farm bills is primarily concerned with the methods and levels of support that the federal government provides to agricultural producers. More generally, U.S. agricultural policy deals with agricultural business, agricultural trade, conservation and environment, domestic food assistance (primarily food stamps) and foreign aid, agricultural credit, rural development, agricultural research and education, and other programs. Debate over U.S. agricultural policy thus involves a diverse group of domestic stakeholders. These stakeholders usually have very different and sometimes conflicting goals. Table 2 shows the different types of stakeholders with their relevant interests in U.S. agricultural policy. It can be argued that the U.S. government is also a domestic stakeholder because it has the responsibility of balancing the interests of different groups and it has to bear the costs of implementing the farm policies.

Within the United States, even though the percentage of the farm population and the direct contribution of farming to national gross domestic product (GDP) have declined over time, the range and importance of interest groups concerned with agricultural policy are expanding. Historically, domestic stakeholders have included farmers of different sizes, agribusinesses, consumers, taxpayers, and other agriculture-related entities. Agricultural policy debates have revolved around issues such as better safety nets for farmers (including higher commodity prices), lower food prices for consumers, and lower agricultural spending for taxpayers. In the past two decades, increased personal incomes and public awareness of social and environmental issues have generated more interest in food safety, environmental quality, and social welfare and brought about new stakeholders such as environmentalists and social advocates. Within this diverse set of interest parties, it should be noted that consumers and small farmers, although apparent stakeholders in U.S. agricultural policy, have little or no influence in policy setting. Large farmers, farmer organizations, and

agribusinesses have been much more influential in crafting U.S. agricultural policies.

### International Stakeholders

U.S. agricultural policy also has international stakeholders. These stakeholders are developed countries such as Canada, the EU, and Japan, whose agricultural policies are in many ways affected by the U.S. policies; and developing countries and their poor farmers who either export to the United States or compete with it in the world market.

High tariffs and over-quota TRQ rates for certain products, like sugar and dairy products, set trade barriers that effectively restrain certain foreign exporters from entering the U.S. market, inflicting welfare losses for these exporting countries. But for nations that enjoy preferential treatment these prohibitive tariffs may be beneficial. For instance, the North American Free Trade Agreement (NAFTA) has made it possible for Mexico to export sugar to the United States to benefit from the high U.S. prices maintained by the *de facto* import quotas applied to all other potential developing-country suppliers.

U.S. domestic subsidies cause more international concern than its market access policies. Subsidies linked to market prices are considered trade distorting. The inclusion of higher loan rates and new countercyclical payments in the 2002 Farm Bill, as well as the continuation of price support programs for a number of commodities, have caused many critics to question the stated U.S. commitment to limit trade-distorting subsidies to agreed-upon levels. Although spending on production- and trade-distorting policies in the United States does not breach the its WTO limits, the sheer size of farm subsidies provided in the 2002 Farm Bill causes concern about the ability of U.S. trade negotiators to persuade the EU and other developed countries to lower their subsidies.<sup>5</sup> And without substantial reductions in subsidies in rich countries, the prospect of a new agreement on agriculture in the Doha Round appears to be slim.

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<sup>5</sup> According to the most recent WTO notification, the total U.S. trade-distorting (amber box) subsidies as measured by the Aggregate Measure of Support (AMS) amounted to US\$14.4 billion in 2001, which is lower than the WTO ceiling of US\$19.1 billion.

**Table 2: Domestic Stakeholders and Their Interests**

Stakeholders	Interests
<b>Small family farmers</b> <ul style="list-style-type: none"> <li>Limited-resource farmers</li> <li>Farming as primary occupation, low sales (&lt;US\$100,000)</li> <li>Farming as primary occupation, high sales (US\$100,000–US\$249,999)</li> <li>Retirement</li> </ul>	<ul style="list-style-type: none"> <li>Income support; credit; education</li> <li>Price and income support; credit; education</li> <li>Price and income support; price stability; credit; education; risk management</li> <li>Income support not tied to production; higher land values</li> </ul>
<b>Other family farmers</b> <ul style="list-style-type: none"> <li>Large farms (sales \$250,000–\$499,999)</li> <li>Very large farms (sales \$500,000+)</li> </ul>	<ul style="list-style-type: none"> <li>Higher and more stable prices; freedom from government regulations; risk management</li> <li>Higher and more stable prices; freedom from government regulations; risk management</li> </ul>
<b>Agribusiness</b> <ul style="list-style-type: none"> <li>Nonfamily farms</li> <li>Processors</li> <li>Throughput companies</li> </ul>	<ul style="list-style-type: none"> <li>Higher and more stable prices; freedom from government regulations; risk management</li> <li>Adequate high-quality supplies; low input prices; high processed product prices; strong export markets</li> <li>Adequate consistent-quality supplies; strong export markets</li> </ul>
<b>Taxpayers</b> <ul style="list-style-type: none"> <li>National</li> <li>Regional</li> </ul>	<ul style="list-style-type: none"> <li>Low program costs; low administration costs</li> <li>Higher local tax revenue from increased incomes and higher land prices</li> </ul>
<b>Consumers</b>	<ul style="list-style-type: none"> <li>Low food prices; food safety; adequate food supplies; variety of food types; healthful food</li> </ul>
<b>Environmentalists</b> <ul style="list-style-type: none"> <li>Conservationists</li> <li>Water quality advocates</li> <li>Wilderness advocates</li> <li>Animal rights advocates</li> </ul>	<ul style="list-style-type: none"> <li>Prevention of soil erosion; preservation of farmland</li> <li>Agricultural practices that limit migration of agrichemicals from farms to water</li> <li>Maintenance of open space</li> <li>Humane treatment of animals</li> </ul>
<b>Rural communities</b> <ul style="list-style-type: none"> <li>Long-time residents</li> <li>New residents</li> <li>Tourists</li> </ul>	<ul style="list-style-type: none"> <li>Maintenance of traditional communities and rural lifestyle; employment opportunities; open space preservation; viability of rural communities</li> <li>Open space; odor control; rural landscapes</li> <li>Rural landscapes; recreational/heritage activities</li> </ul>
<b>Social welfare advocates</b> <ul style="list-style-type: none"> <li>Civil rights advocates</li> <li>Antipoverty advocates</li> <li>Agrarians</li> </ul>	<ul style="list-style-type: none"> <li>Adequate economic opportunities for minorities; opportunities for minority farmers</li> <li>Provision of minimum income levels for rural residents</li> <li>Maintenance of viable small-scale agriculture</li> </ul>

Source: ERS, USDA 2006a.



Many believe that the U.S. 2002 Farm Bill, and farm bills in general, have a significant, and in most cases, damaging impact on the farm sectors and national economies of many developing countries. High U.S. subsidies induce overproduction, which in turn depresses world prices, meaning that poor-country farmers earn less for the products they sell. Gradually, they are driven out of the world market as well as their own local markets, as they simply cannot compete with the prices of dumped goods, which are sometimes priced even lower than production costs (world cotton prices, for example, are now well below average production costs). In most developing countries, agriculture remains the essential, and sometimes the only, driver for economic growth, rural development, and poverty alleviation. Dumping highly subsidized agricultural commodities into developing countries destroys their only opportunity to grow and further impoverishes their economies. At the household level, lost commodity sales deprive farmers of their ability to send their children to schools, to access basic public services, to buy medicines, and to feed their families. For countries that are heavily dependent on commodity exports for foreign exchange earnings, dumping can also lead to severe trade imbalances and substantial risks of debt crises.

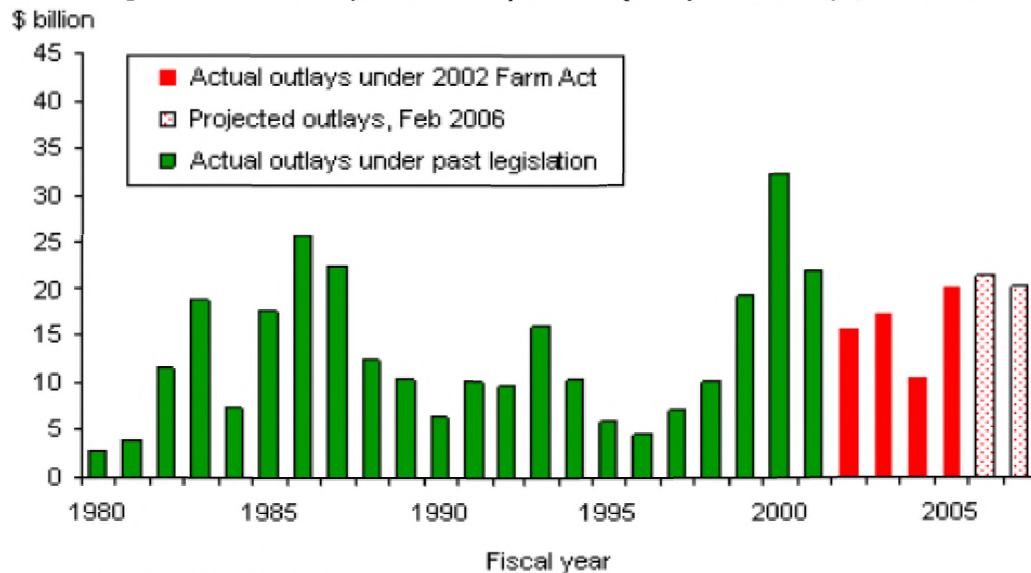
## Policy Issues

### Budget

All the U.S. domestic farm support payments are financed by the Commodity Credit Corporation (CCC), a wholly owned government corporation chartered in 1933 to stabilize, support, and protect farm incomes and prices. In addition to price and income support programs, the CCC also provides export subsidies and support for certain conservation programs such as the Conservation Reserve Program (CRP). CCC borrows money from the U.S. Treasury and repays the borrowing from program revenues and congressional appropriations.

The pressure to reduce the federal budget deficit and to control agricultural spending necessitates a reform of current farm policy. CCC outlays are now projected to average over US\$20 billion annually through fiscal year 2007 (Figure 3), at a time of a deepening federal deficits and more pressing national priorities. For example, as the U.S. population ages, the country will see greater demand for budget spending on Social Security, Medicare, and Medicaid, which already account for more than 40 percent of the total U.S. budget. Moreover, the return to large federal deficits means that more of the federal budget will be allocated to interest payment on national debts.

Figure 3: Commodity Credit Corporation (CCC) Net Outlays, 1980–2007



Source: ERS, USDA 2006a.

## Trade

The commodity program provisions in the 2002 Farm Bill have attracted widespread criticism from those in the United States and abroad who view them as reversing the market-oriented course the U.S. Congress had charted for long-term farm policy in 1996. These critics argue that the bill perpetuates outmoded, commodity-oriented policies that tie support to the prices of a few major crops (Tweenten 2002). With legislated target prices and loan rates set well above market prices, U.S. producers will continue to overproduce supported commodities, distorting market prices and global trade and causing trade disputes. The recently resolved dispute with Brazil on upland cotton subsidies and unfavorable WTO rulings against the United States illustrate the urgency of reform.

Furthermore, the adoption of expanded farm subsidy programs as reflected in the 2002 bill has undermined U.S. credibility in world trade negotiations, where the United States has called on other countries to reduce their own trade-distorting agricultural subsidies. As part of the URAA, countries committed to continue reform. Negotiators have already agreed on a framework that commits countries to reduce domestic support (20 percent over a 6-year period for developed countries and 13 percent over 10-year period for developing countries). The political reality, however, appears to be that there will be no agreement without further reductions in subsidies. To level the agricultural playing field and gain additional foreign market access, the United States will have to reform its current farm policy by reducing outlays on trade-distorting domestic support programs.

Though less controversial than farm subsidies, high tariffs, especially over-quota rates, have also raised international concerns. The United States, along with the EU and Japan, has a large number of TRQs with high over-quota tariffs designed to prevent imports. In many cases these over-quota tariffs are megatariffs of greater than 100 percent as illustrated earlier. In addition to the several hundred tariff lines covered by TRQs, the United States maintains a list of sensitive products as defined in the Trade Promotion Authority, which covers 184 tariff lines. A closer look at the U.S. tariff profile shows that there are a large proportion of non-*ad valorem* tariffs, which are generally

more protective, especially when prices are low.<sup>6</sup> Furthermore, even though the United States has a substantial number of zero-tariff lines, there are also many tariffs higher than 12 percent. Many of the TRQs and high tariff lines apply to agricultural products in which developing countries may have a comparative advantage. These products include sugar, dairy products, beef, tobacco, fruits, and vegetables.

## Social Equity

The rise in farm incomes may justify a cut in agricultural program spending. According to the U.S. Department of Agriculture (ERS, USDA 2006a), net farm cash income has increased from an average of US\$50 billion per year during the 1990s to more than US\$80 billion in recent years. Average household income for farm operators reached US\$80,000 in 2005, well above the national average income of US\$45,000 in that year. Today, farm poverty is at its lowest level in U.S. history owing to the availability of remunerative off-farm employment and on-farm gains in labor productivity. Thus, general safety net programs, such as food stamps or Medicaid, may be more helpful in reducing farm poverty than traditional commodity programs.

Rather than being awarded with regard to need, subsidy payments are based on the types of crops grown. More than 90 percent of all farm subsidies are allocated to farms that produce just a handful of agricultural products in the United States. In addition, current agricultural policies are designed to concentrate farm subsidies among large farms and agribusinesses. Larger farms earn higher incomes, but they are also the ones who benefit more from the farm program payments. In 2004 the largest 7.5 percent of farms in terms of gross receipts (earning over US\$250,000 annually) received 56 percent of all government payments (ERS, USDA 2006a). Government assistance programs have also benefited landowners more than growers since these subsidies are capitalized into land values, thereby driving up rental rates. In sum, the current farm policy achieves little in terms of social equity.

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<sup>6</sup> An *ad valorem* tariff is levied as a fixed percentage of the value of the commodity imported.

### Political Feasibility of Reform

If any reform to the U.S. agricultural policy is to take place, there is the issue of political feasibility. To the extent that current domestic and trade policies prop up domestic prices and generate higher farm incomes, farmers and farmer groups are not likely to find a change appealing. Because the largest farm groups and agribusinesses are the chief beneficiaries of agricultural policy, they have both the incentives and the resources necessary to invest heavily in maintaining current policies and choke down efforts to reform. Through representative organizations, they have served on federal commissions, testified before Congress, and donated millions of dollars to federal political candidates. Not surprisingly, the House and Senate farm bills include many of the provisions that these groups support, including massive farm subsidies and price supports. Correspondingly, protective trade measures are put in place to supplement domestic farm support. As a result of a strong agricultural lobby, policy reform may not occur for the U.S. agricultural sector in general and for some commodities in particular, like sugar and dairy products. Farmer groups have successfully blocked constructive proposals in recent farm bills and negotiations at the Doha Round.

### Policy Options

#### Domestic Support

A number of operational approaches are available for reforming domestic support in the United States. First, the post–New Deal “cash-out” farm payments could be continued and expanded.<sup>7</sup> For example, shifting to cash-out payments for commodities such as sugar and dairy would provide gradual and partial reform that would reduce the market intrusiveness of current farm programs over the long run by offering beneficiaries a continuous stream of cash compensation payments. The benefits of pursuing a cash-out system for these commodities would be fewer market distortions, fewer production restraints, and more competitive export pricing. But cash-outs also have drawbacks. It is not clear how much cash-out

measures have decoupled farm support from production decisions and trade effects. Even when decoupled, a cash-out system entails an open-ended commitment to support payments. Dirty decoupling under a cash-out and the ongoing character of the subsidization remain obstacles to trade liberalization.

Alternatives to the cash-out approach for ending intrusive farm program interventions, or even for ending a cash-out itself, can be distinguished based on the speed of reform implementation and whether or not compensation is provided to beneficiaries of the programs (Table 3). A buyout is a quick termination of support entitlements, made politically palatable through significant but temporary compensation up front, in the form of a large cash windfall. A squeeze-out is an incremental reduction in the market intrusiveness and generosity of farm programs, managed slowly enough to avoid triggering a defensive backlash from lobby groups representing subsidy-dependent farmers, yet significant enough over time to reduce distortions and costs and to inspire voluntary non-participation by market-oriented commercial farmers. A cutout is a quick termination of all program support entitlements without compensation. None of these alternatives to a slow compensated cash-out has proven feasible on a large scale in the United States [Orden et al. 1999].

#### Market Access

The URAA approach to agricultural tariff reduction kept in place two characteristics that describe the current profiles of global agricultural tariffs: (1) differences among countries in their average agricultural tariff; and (2) variation, or dispersion, in tariff rates across commodities within countries’ tariff schedules. The average U.S. agricultural tariff of 12 percent is relatively low in comparison with average agricultural tariffs in Canada (24 percent), the EU (21 percent), Japan (33 percent), and Norway (152 percent). Compared with other industrialized countries, the United States also has a unique tariff dispersion: more than 50 percent of its tariffs are extremely low, at 5 percent or less, while only a very small share exceed 100 percent [Wainio et al. 2001].

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<sup>7</sup> Orden et al. (1999) define “cash-out” payments as taxpayer payments to farmers to replace the support programs that previously propped up commodity market prices.



**Table 3: Alternative Farm Support Reform Strategies**

Compensation	Speed of Implementation	
	Slow	Fast
Yes	Cash out	Buyout
No	Squeeze out	Cutout

Source: Orden et al. 1999.

Further tariff reforms in the United States can take two broad approaches: formula and sectoral approaches. The formula approach defines some general rule that applies to all tariffs, whereas the sectoral approach focuses on one commodity or commodity group. Within the formula approach, there are two types of formulas for targeting the level and dispersion of tariffs: linear reductions and harmonization. A linear reduction formula reduces the average tariff rate by reducing all tariffs proportionately. In contrast, harmonization formulas target tariff dispersion through progressively larger reduction of higher tariff rates. In practice, many of the tariff reduction formulas proposed in past trade negotiations have included variants that address both tariff levels and tariff dispersion. Many combine some overall reduction of the average rate with harmonization so that all tariffs are reduced while the problem of tariff dispersion is not worsened.

There is also a need to reform the TRQs in the United States, although there is no single best way to do so. One reason is that individual TRQs vary with respect to the component of the TRQ (under-quota tariff, quota, or over-quota tariff) that restricts trade. For under-fill TRQs, the within-quota tariff is the binding constraint, so reducing the within-quota tariff is likely to increase market access. In contrast, market access will be enhanced by lowering the over-quota rate for over-fill TRQs. In addition, an infinite expansion of quotas would eliminate the quota system, and the TRQ would then become a simple tariff regime. In the Doha Round, the United States has proposed eliminating all in-quota tariffs and enlarging all quotas by 20 percent.

### Export Subsidies

The URAA approached the reform of export subsidies by placing restrictions on both the volume and the value of subsidized exports. Targeting both components creates effective constraints in times of both high and low prices. When prices are low, both the value and the volume limits act as constraints. These limits help to prevent the disposal of excess supply onto export markets, in an effort to raise low domestic prices. Value limits become more binding as prices fall because the subsidy (the difference between the high internal support price and the declining world price) becomes larger. When world prices are high, the value constraint becomes less binding, but the volume constraint can still set some limit on export subsidies.

Compared with other developed countries, especially the EU, the United States has made limited use of export subsidies. Consequently, it is pushing hard to roll back or eliminate export subsidies in the current negotiations. Although direct export subsidies are small in the United States, various other export support programs exist, many of which are controversial. For example, in the recent cotton dispute with Brazil, the WTO dispute settlement body found the popular export credit guarantee programs to have functioned effectively as direct export subsidies to cotton exporters, because the financial benefits returned by these programs failed to cover the programs' long-run operating costs. This finding applies not just to cotton, but to all commodities that benefit from U.S. commodity support programs and receive export credit guarantees. As a result, export credit guarantees for any recipient commodity are now subject to previously scheduled export subsidy commitments for that commodity. Since the United States has proposed to phase out all direct export subsidies, a viable strategy to maintain sufficient



support to agriculture without violating WTO rules is to switch from direct export subsidies to direct payments.

### Enhancing the Feasibility of Reform

Several steps can be envisioned that would improve the prospects for adherence to reform in the United States. Domestically, eliminating the permanent legislation for farm support programs will put an end to trade-distorting farm support policies. In the international arena, a new WTO agreement on agriculture built around tighter limits on U.S. amber box measures, as well as higher reduction commitments on tariffs and export subsidies, might also provide effective enforcement mechanisms.

Consumers can influence the adoption of reform to the extent that their demand behavior contributes to declining benefits under old policy regime. But experience from past agricultural reforms suggests that a policy change will require substantial support from producers. The emergence of such support depends on either shrinking benefits for producers in the old policy regime or the potential expansion of benefits in the new policy regime. Any policy change generates benefits and costs, however, and the acceptance or refusal of a reform depends on whether affected producers are net winners or losers. For producers who are net losers, compensation is necessary and should be made lucrative enough to bring about support from this group.

### **Assignment**

Your assignment is to design a policy reform package (in terms of domestic support, market access, and export subsidies) that is both politically feasible in the United States and beneficial for the developing countries.

### **Additional Readings**

- Becker, G., and J. Womach. 2002. The 2002 Farm Bill: Overview and status. Report for Congress RL31195. Washington, DC: Congressional Research Service.
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